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20 May 1975

MEMORANDUM FOR: Mr. James Carnes [redacted]
OASD/ISA/IEA
Department of the Defense

SUBJECT : The South Korean Economy

In response to your request we are forwarding the attached report on the South Korean Economy for use by the Deputy Assistant Secretary of Defense for International Economic Affairs, Dr. Roger E. Shields. If there is any further information on this or related matters which you may require, please feel free to call.

[redacted] [redacted] 25X1A9A

Chief, [redacted] Pacific Branch 25X6
Industrial Nations Division
Office of Economic Research

Attachment:
As stated

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THE SOUTH KOREAN ECONOMY

CURRENT SITUATION

1. South Korea's economy has been hard hit by the worldwide economic slump. Although real growth last year averaged around 8%, all the gain came in the first half. The downturn has spilled into 1975 when real growth will probably register only slight gains. Seoul will certainly be unable to achieve anything near its goal of 7% real growth this year because of continued weak demand in major industrial countries which take the bulk of Korea's exports. The payments deficit, after bulging last year, will remain large in 1975.

2. Despite current economic problems, South Korea's long-term prospects remain good. The economy is structurally sound with solid growth prospects once demand in the United States and Japan, Korea's chief foreign markets, revives. The country's low wage, skilled labor force and broadening industrial base makes it a still attractive site for foreign investors. Given these positive attributes, Seoul is unlikely to alter its military or political thinking on the basis of current short-term economic conditions.

THE DOMESTIC ECONOMY

3. Real output, after increasing sharply during the first half of 1974, stagnated in the second half. Although official data indicates some moderate production gains occurred in the first quarter of this year, the improvement was well below Korea's normal growth pattern. Output in most major industries remains depressed, particularly industries that export the bulk of their output. At the end of last year, output in the important textile industry, for example, was down 20% from the early 1974 peak. Plywood, electronics and some heavy industries have also been hard hit.

4. The slump has pushed unemployment up substantially. At the end of 1974 official data, which tends to understate the situation, put employment at 5.6%. The trend towards layoffs and short hours continued in the early months of 1975. Employer groups and the government remain concerned over possible labor unrest although no serious incidents have occurred. Foreign-owned firms have faced some government pressures to maintain their

labor force despite sagging output. A large number of local firms have gone bankrupt over the course of the slump, although most were small-sized operations.

Government Policies

5. Government policies are essentially aimed at bolstering employment and output. Stimulative measures initiated last November, however, are being tempered because of inflation and balance of payments problems. After shifting from a budget surplus to a large budget deficit, Seoul now is trying to pace its outlays to keep the fiscal stimulus within limits. Public works, welfare, and defense outlays nonetheless continue to rise. Seoul is also providing loans to firms to help avoid bankruptcies and maintain employment.

6. Government policies have failed to substantially slow the rate of inflation. Consumer price increases in early 1975 were still running at a 23% annual rate, down only slightly from last year's 25% rate. Wholesale price increases have slowed only slightly, partly because of labor's effort to win catch-up wage hikes and the limited productivity gains achieved during the slump. For the past year Seoul has attempted to influence price movements by maintaining controls over a variety of key commodities including electricity, as well as consumer products such as cigarettes. Price controls have provided only temporary relief at best.

7. A key factor in the continuing inflation was Seoul's decision to permit a 17% won devaluation in December. The currency adjustments, aimed at stimulating exports and damping import demand, resulted in a substantial increase in the domestic price for import products. The urban population was affected most by the price hike because a large share of food supplies are imported. Seoul eased the impact on farmers by increasing subsidies for imported items such as fertilizers.

Trade and Payments

8. Seoul's most pressing economic problem is the country's deteriorating trade and payments position. Last year's trade deficit jumped to $1.7 billion largely because of higher oil and other commodity prices. The current account deficit was $1.8 billion, up from $300 million in 1973. We estimate the current account deficit in 1975 will approximate $2.4 billion. Most of deficit will occur during the first half. Seoul hopes to reduce the second half deficit to only about $800 million.

9. Underlying this year's payments problem has been a collapse in foreign demand for Korean goods. The decline began in mid-1974, accelerating since then. Exports to Japan in early 1975, for example, were 40% below the year earlier. Sales to the US market have barely held their own. Imports meanwhile are running double year-earlier levels. Seoul hopes to substantially reduce the import bill by tightening import controls and restricting foreign exchange available to purchase imports.

10. The trade imbalance has placed Seoul in a serious international financial bind. Last year's deficit was financed with little difficulty through long-term capital inflows and a substantial increase in short-term foreign borrowing. By the start of 1975, however, financing the deficit required a large drawdown in foreign exchange reserves. During the first quarter of 1975, gross reserves declined by nearly $200 million. By March, foreign exchange stringencies were more severe than at any time in the recent past.

11. Although the financing problem remains serious, we think Seoul will manage to sqeeze by the next several months without resorting to further sharp exchange drawdowns. The government will be able to draw funds from a number of sources including the balance of a $200 million US bank loan and up to $250 million from the IMF. Seoul will probably have at least some success in lining up funds from Japan, and European sources as well as the World Bank. The largest single financial package may come from Saudi Arabia which reportedly has tentatively agreed to provide loans of up to $500 million.